Financial Markets Transition from Traditional Finance to Behavioural Finance

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Abstract

Financial Market can be categorized into Traditional Finance often identified as Conventional Finance, and the recently developed Behavioural Finance. Earlier in the Financial Market, the focus was on the Traditional Finance theories of Efficient Market Hypothesis and Harry Markowitz Model based on investor's rationality. In the year 1990's the conventional finance theories were questioned due to their unacceptable assumptions. Financial markets have become global and has been influenced the numerous factors such as institutional and political constraints, information dissemination, economic processes which occurs in the country, and amongst them the most important factors are people's perception and reaction. In this research paper, an attempt is made to study the paradigm shift from traditional finance Theories to behaviour finance and to highlight the importance of Behavioural finance.

Keywords: Traditional finance, rationality, Behavioural Finance.

Introduction

Finance in any organization is analogous to a flow of blood in the human body. Companies and enterprises require capital to expansion and diversification to stand in the competitive world. Capital can be raised through Financial Markets by companies. Financial market is the place where various financial assets are bought and sold by participants. Financial assets comprises of various securities issued by companies such as debentures, shares, bonds and stocks to raise funds. Thus, studying financial market has been centre of attraction for various research scholars.

Different theories have been developed and have broadly classified the financial market into Traditional Finance and Behavioural Finance theories. Traditional theory is based on the concept that investors act rationally, their aim is to maximize profit and they are usually risk-averse. These assumptions that market is efficient are violated because of speculations and unpredictability in the market often termed as "market anomalies". Thus, an alternative theory was developed which is termed as "Behavioural Finance "which emphasizes on sociological and psychological aspect of decision making of investors. This theory stresses upon market inefficiencies and anomalies.

Behavioural Finance is a new concept which relates to studying the psychology of investors and how it affects in financial decision making. It indicates that human behavior and emotions do influence their decision making. Information is readily available worldwide and people reacts to such emotions in seconds. This leads to illogical changes in the prices inspired by the news received and moods of investors, which times may also result in disasters in stock market due to the irrational and inefficient behavior of investors. Behavioural finance covers the two aspects-Behavioural Finance Micro which studies individual investor's behavior and Behavior Finance Macro that detects efficient market hypothesis anomalies.

Literature Review

Lal (1992) used sample size of 1,200 individual investors to examine their portfolio from different areas and regions of India. His study showed that investors in India prefer portfolios in his study conducted on more than 5 companies.

Table 1: Financial Market Anomalies and Possible Investor Bias.

Financial Market Anomalies	**Possible Investor Bias**
Market Over-reaction	**Overconfidence**
Market Under-reaction	Conservatism/anchoring/availability bias/confirmation bias/represenativeness/belief perseverance
Excessive volatility	**Overconfidence**
Momentum	**Overconfidence**/availability bias/confirmation bias/herding.
Post-earnings announcement Drift	**Overconfidence**/availability bias/confirmation bias/herding.
Panics and Crashes	**Overconfidence**/availability bias/confirmation bias/herding
Holding losers too long/selling winners too quickly	Disposition Effect/prospect theory.

Shefrin (2001) defined behavior Finance has been influenced by psychology of human mind and affects financial decision made by them. Daniel Kahneman (2002) gave an insight showing integration of psychological research and economic science.

Pompian (2006) studied that behavioral finance is based on two aspects- individual investors and entire market, in a broad sense, behavior finance is classified into Micro behavior finance and Macro behavior finance. Macro studies market anomalies of the theory of efficiency in market and Micro behavioral finance focuses on individual investors behavior decisions and distinguishes them from rational thinkers, who acts according to mathematical and statistical models.(Jurevicienece et al. 2012).

Kannadhasan (2006) showed in his study that conventional finance is categorized into two models- Markowitz and Efficient Market hypothesis but there are other factors also which influence the investors.

Table 2: Types of Biases

Emotional Biases	Cognitive Biases
1. Status Quo Bias	1. Availability Bias
2. Regret Aversion Bias	2. Framing Bias
3. Loss Aversion Bias	3. Self Attribution Bias
4. Confirmation Bias	4. Overconfidence Bias
5. Optimism Bias	5. Cognitive Dissonance Bias
6. Self Control Bias	6. Hindsight Bias
7. Endowment Bias	7. Mental Accounting
	8. Anchoring And Adjustment Bias
	9. Ambiguity Aversion Bias
	10. Representativeness Bias
	11. Conservatism Bias
	12. Illusion Of Control Bias
	13. Recency Bias

Source: Pompian (2006)

Tseng (2006) suggested combination of traditional efficient market hypothesis focusing rational behavior of individual and financial behavior & neural finance. Tseng suggests that new propsed Adaptive market Hypothesis is more accurate than Traditional efficient market hypothesis. As conventional finance is based upon:

a. Expected risk and return
b. Risk is measured under CAPM
c. Price is contingent claim
d. Modigiliani-Miller Model

The above are based upon investor's rationality. However traditional finance don't answer the following questions:

a. Why and how an investor trades?
b. How an investor frames portfolio? and
c. Deviation of returns due to risk?

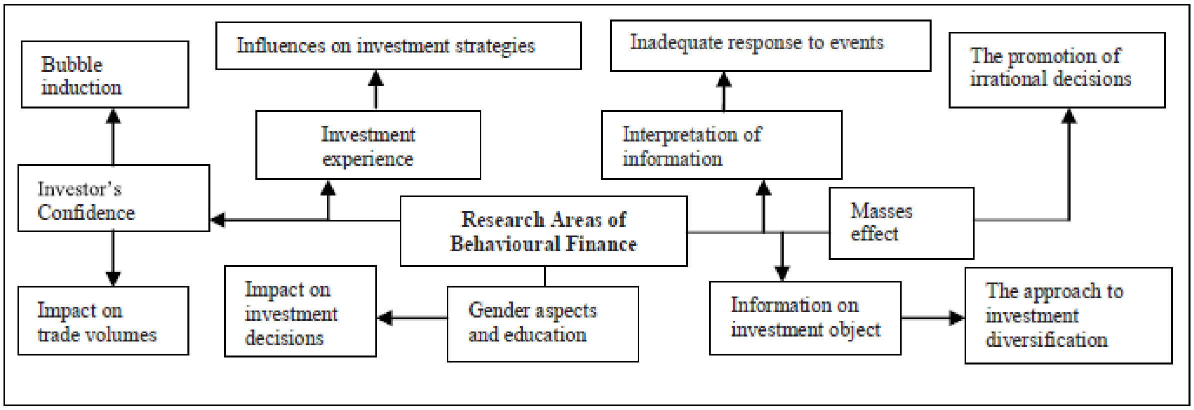

Figure 1. Research areas of behavioural finance

Bodie et al (2007) describes behavioral finance focuses upon the psychological factors intervening investors behavior.

Sewell (2007) studied the overview of development of behavior science and explained by various research scholars.

NCAER (2008) examined 60,000 rural and urban households to study financial security, savings and investment decision take by individual investors. He concluded that people tend to save for long- term period and tend to save in post office schemes and bank accounts and other risk free liquid assets rather than investing their funds in stock market.

Jordan & Miller (2008) have studied behavioral finance through individual's emotions and attitude towards market prices and investment decision making process.

Graham, et al. (2009) assessed that small investors don't rely on expert's experience but on their competence. A empirical model was developed was developed to determine trade frequency on the basis of the investors competence. It was studied that investor who feel confident trade more and have a diversified portfolio. Researchers found that male investors or highly educated have more diversified portfolio in comparison to women or investors with lower education. So, confident investors trade more and frequently.

Walia and Ravikiran (2009) studied the investor's preference towards mutual funds in the State of Punjab, India, by studying the sample of 100 individual investors. He examined using chisquare, ranking and rating, anova and concluded that the investor preference for mutual funds varies.

Parashar (2010) study described that demographic and personality affects the investor behavior. He examined personality traits that affect investor's choice by using sample size of 100 individual investor and applying test, and factor analysis, cluster analysis, correspondence analysis and Kruskal Wallis.

Kabra et al. (2010) described that investor's age and gender affects risk-taking potential, using the sample size of 100 investors who work in government and private sectors.

Arvid (2010) analyzed that systematic differences impact the portfolio's of an individual and supports behavioral approach in comparison to portfolio theory.

NACER (2011) studied the behavior of households in towards various financial instruments traded in stock market under the regulation of SEBI across 44 cities and 40 villages and taking the sample of 38,000 households. His study concluded that investors are risk-averse as degree of risk aversion is extremely high amongst them.

Dawar and Wadhwa (2011) conducted their study in State of Punjab by taking the sample size of 275 residents staying in area of Jalandhar and found that accounting information, neutral information, self- image, advocate recommendation, personal financial needs and social relevance influence the investors in decision making.

Thomas, Joost M. (2011) explained the impact of financial crises during the year 2007-09 using the record of their clients and survey based on monthly data. His study showed that investors having higher risk perception has more turnover in comparison to lower risk perception.

Hon- Shiret al.(2012) explained five behavioral biases in stock market of investors in decision making are hot hand fallacy, gambler's fallacy, herd behavior, availability heuristic.

Konstantindis et al. (2012) concluded that generation ago, it was widely accepted by finance analysist and economists. He further quoted that despite of the fact efficient market hypothesis is central theory of finance but yet it is not free from critics on many grounds. Decision making s a complex activity. Decisions can’t be taken on the basis of personal resources, many scholars have investor rationality.

Subash(2012)his study found that anchoring, hindsight and gambler fallacy biases affects the younger investors more in comparison to the experienced ones by taking the sample size of 92 respondents.

Lubna (2012) highlighted individuals difference arise due to factors like. Age, race, demographic factors, education level, sex, economic and social background.

Hilbert (2012) showed that retail investors and other individuals are influenced by overconfidence, reinforcement and herding in comparison to institutional investors.

Coffie (2013), his study showed a positive correlations between the behavior finance theories and stock investment strategies. The results from his study also showed minor correlations between various strategies and Prospect, Anchoring, Regret Theories and Herding.

Suresh (2013) justified that various biases and financial traits such as loss aversion, endowment effect, hindsight bias and anchoring helps in financial decision making.

Abhijeet Chandra & Ravinder Kumar (2014) studied factors that affect individual behavior and found five psychological axes that individual investor have while taking decisions. The underlying variables were under confidence, prudence and precautious attitude, conservatism, financial addiction and information asymmetry.

Chitra K. & Jayashree T. (2014) collected data from 110 investors and investigated the impact of demographic factors using ANOVA, descriptive analysis, and factor analysis test. He concluded that five factors that mainly affects investor behavior namely Conservatism, Regret Aversion, Overconfidence, Price Anchoring, and Representativeness.

Dhole (2014) a study was conducted on the medical students to examine the behavior characteristics such as mental accounting, gambling, herding etc.

Neelakatan (2015) developed a model using structural model equation (SEM) for studying the investor’s behavior. Results of his study showed the relationship between demographic factors and psychological biases influence the investors in taking investment decisions.

Sukheja G. (2016) studied emotions, biases, and moods that influence investor behaviors using empirical research. This study explained that anchoring and overconfidence factors have an impact on decision making.

Mounika (2017) in her study concluded that practically, investors are do not act rational, they are affected by the behavioral biases while taking financial decisions related to investment.

Research Objectives

In this research major research objectives are as follows:

1. To study the shortcomings of Traditional Finance Theory
2. To study the difference between Traditional Finance theory and Behavioural Finance Theory.
3. To highlight the importance and Growth of Behavioural Finance Theory.

Research Methodology

Type of study- Research paper is based upon descriptive and conceptual study. Sources of data- secondary data are based on papers, journals, articles on the internet based sources related to conventional and Behavioural Finance. Various journals and books which are available in physical form were studied to develop the Research paper.

Analysis

Limitations of Conventional Finance

1. **Rationality Concept:** traditional finance is based on the bed rock that investor behaves rationally, but this assumption is the major shortcoming of the theory, studied by various research scholars. Rational behavior is defined as a proper and best use of information possessed by investors and analyzed in an objective manner. But investor is a social human being due to his emotions he may behave in irrational manners, they may become biased and overlook at the rational attitude.

2. **Emotional Attitude of Investors:** traditional finance undermines role of emotions of investor in making the investment. Investors are social beings, therefore, role of emotions

can't be avoided in field of financial decision making.

3. **Accuracy of Information:** traditional finance assumes that investors have access to all the available information and same is reflected in stock prices. But in practical life, same is not possible because investors can't access every information at the same time.

4. **Experience:** other assumption of traditional finance is that all the investors have same level of knowledge and expertise. But practically an experienced investor will make wiser and better decisions than those who have started trading in the market.

5. **Demographic factors:** income, sex, age, background, religion, family etc, are the various demographic factors that are not considered in conventional finance.

Growth of Behavioral Finance

Investors have a common behavior when they make decisions related to investment, such as:

a) **Investors don't consider all the available assets and securities:** according to Kent et al. (2001), an investor will give attention to stocks and securities which are shown up on the radar screens. This based upon the fact that familiarity or exposure to product is considered less risky and more attractive.

b) Investors behaves loss-averse in the market: Kent et al. (2001),studied that investors tend to sell the stock that have higher value in comparison to assets whose prices have dropped, therefore, investors are considered as risk averse. They are not ready to sell the stocks at loss in relation to selling them at loss. This helps to develop a strong relation between volume in comparison to price movement.

c) **Representative Biases:** Investors believes that past performance also indicates future performance in making decisions for stock. Investors do technical analysis by studying past performance of stock prices. It relates to judging the likelihood on the basis of naïve comparison of present characteristics of event with predicted characteristics, this is often known as representative biases.

d) **Aggressive behavior of investors:** Investors are overconfident while making decisions for investment. They tend to overreact to unreliable information more in comparison to reliable one. Odean (1999) showed that male investors have more aggressive behavior in comparison to female investors, in financial markets. Kent et al. (2001)- Barber & Odean (1999) quoted that investors who have good past experience will trade more in the future, this evidence is based on self- attribution bias, meaning that investors considers past success as their skill rather than luck.

e) **Herding behavior:** investors act in parallel to each other they blindly follow what other investors perceive rather than analysis on their own.

f) **Inefficient portfolio:** investors all the time will not form efficient portfolios.

g) **Anchoring:** Investors beliefs are influenced by historical high or low performance of the stock price, they consider the market is based on irrelevant historical values, this is known as anchoring.

Implications of Behavior Finance:

As quoted by Albert Einstein "Only two things are infinite, the universe and human stupidity, and I'm not sure about the former". Human minds can do wonders and but also blunders in few cases. This gives rise to the new concept of behavioral finance, which keeps aside the assumption of individual rationality. Behavior finance also incorporates irrational psychological biasness related to investment earlier which was avoided under the traditional finance.

Behavioral finance states that investors decision making is not influence by any equilibrium and theories, but the principle of behavioral finance are based on various emotional and cognitive illusions.

Cognitive Dissonance: it means disharmony of thoughts while taking decisions for investment. It is a mental discomfort that investor has while taking any decisions which are contradicting his set of attitudes and beliefs. Under this scenario, he tries to relive his mental discomfort using different irrational heuristic decision process.

Heuristic is a strategy, through which people make decision, solve problems and come to judgments. They develop a rule of thumbs by using hit and trial method. But at times it might result in systematic cognitive biases. Heuristic effect has led to following biases:

a) Herd behavior: as explained above**,** it is a most common behavior observed in financial market, where individual investors tend to follow the decision taken by majority, rather than relying on their own rationality. Investors are psychologically pressurized to refrain or take any action because of the peer pressure amongst them. The main reason of herd behavior is because of the fact that individual investors are more concerned about the investment decisions of the other investors in the financial market.

Table 1: Theories of Behavioral Finance

The Prospect Theory	Heuristics
Loss aversion	Herd behavior
Mental accounting	Overconfidence & over under reaction
Self control and regret	Anchoring

Source: Johnsson, et al. (2002)

b) **Overconfidence bias:** these investors believe that their personal assessment and valuation for security is more accurate than the valuation by other. Psychologist says that overconfident investors exaggerate their ability of controlling event, undermines risk and overestimates their knowledge.

c) **Anchoring:** it is the tendency of the human beings that they rely too much on the one piece of information, or trait, while making the investment decisions, this is known as anchoring. When the investors receive new information, they anchor it by recent observations. They assume the trend of earnings will co-align with historical trends in earnings, which results in under reactions in trend changes.

Prospect Theory

This theory concludes that investors are risk-takers for losses and risk-averse in gain. Investor's attaches different value to gains and loss and place more value to perceived gains in comparison to perceived loss.

a) Loss and Regret Aversion: holds that it is psychological that people pay more attention to regret of loss in comparison to pleasure of gaining anything. This theory is encapsulated in the expression "losses impend larger than gains". Basic principle that governs this theory is why penalty frames are more effective than reward for motivating people.

b) **Mental Accounting:** It is a process under which people evaluate their financial transactions.

Conclusion

Behavioural Finance is concerned with studying the investor's psychology and sociology prospective from point of view of investor. Behavioural Finance relaxes rationality assumption of traditional finance theory and explains the psychological biases that influence investors in real life. These biases get converted into behaviour of investors which results in taking sub optimal decisions by them. At times it may lead to market disruptions if caused on large scale, this is known as market anomalies.

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